BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
UNITED LINEN SUPPLY COMPANY)

Appearances:

For Appellant: Joseph Haas, Attorney at Law

For Respondent: John S. Warren, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the protests of United Linen Supply Company to proposed assessments of additional franchise taxes for the following years and in the following amounts:

Income year ended	Amount
March 31, 1941	$5,872.64
" 1942	3,501.81
" 1943	7,292.73
" 1944	7,237.03
" 1945	4,663.58
" 1946	5,377.41
" 1947	5,784.29
" 1948	9,998.81
" 1949	6,032.62
" 1950	9,436.93
" 1951	8,680.24

Appellant is a Delaware Corporation doing business in Los Angeles, California, National Linen Service Corporation, hereafter referred to as "National", owned 58.64% of Appellant's Class A preferred stock and 58.29% of its Class B preferred stock during the years involved herein. Linen Service Corporation of Texas, a subsidiary of National, owned 99.99% of Appellant's common stock from 1939 to 1947 when it was merged with National, Since 1947 National has owned this common stock itself.

All of these corporations were in the linen supply business. National began its linen supply business many years ago in the southeast portion of the United States. It later

organized Linen Service Corporation of Texas to expand its business to the southwest and further extended its activities when it acquired Appellant's stock in 1939. In 1945 it acquired a part interest in Galland Linen Supply Company which operated in the San Francisco area. In 1948 Galland Linen was merged into National with the result that at the end of that year National operated through various branches and one subsidiary (Appellant). In 1955 Appellant was merged into National.

Appellant and National had interlocking boards of directors. The president of National was also the president of Appellant. Sales and managerial personnel were shifted between the various branches of National and Appellant. National's central office provided accounting services to each branch office and to Appellant. National did the billing for most of the branch offices, but did not perform this bookkeeping service for Appellant.

Appellant and National rented linen supplies and towels to business concerns and individuals, e.g., barber shops, motels, restaurants, and professional offices, such as those of doctors and dentists. The linen supplies were rented clean to the customer at an agreed upon price. As the linens became soiled they were picked up at prescribed intervals and replaced with clean linens. The Appellant, and each of the branches of National, operated plants where the linens were washed and stored. They also maintained fleets of delivery equipment to get the clean linens to the customers and to pick up the soiled linens.

National also engaged in manufacturing operations and produced some of the goods and equipment used in the rental operations, such as white goods (towels, linens, and garments), soap, cabinets, laundry machinery and truck bodies. These were available to Appellant at cost. National also centrally purchased goods, including linens and office supplies, from other manufacturers in large quantities. Appellant purchased these goods from National at cost plus two percent. Approximately one-third of the cost of Appellant's total purchases for the years in question, including such items as fuel and power, represented purchases from National. Approximately one-half of its total purchases of linen, the largest item, was from National.

Appellant filed separate franchise tax returns for the years in issue and reported its income and expenses upon a separate accounting basis. Since the merger of Galland Linen Supply Company with National in 1948, National has filed California returns for each year, in which it computed income

attributable to the San Francisco branch by the three factor formula of property, payroll and sales (rental receipts). The Franchise Tax Board determined that Appellant, National, and Linen Service Corporation of Texas were engaged in a single, unitary business and computed Appellant's tax by applying the three factor formula of payroll, property, and sales to the combined income of the group.

Appellant contends, initially, that its income cannot be combined with that of National and Linen Service Corporation for purposes of allocation because its income is derived solely from sources in this State. The application of the allocation provision, Section 10 of the Bank and Corporation Franchise Tax Act (later Section 24301 and now Section 25101 of the Revenue and Taxation Code), is premised upon the requirement that the income of the bank or corporation be "derived from or attributable to sources both within and without the State." Appellant's contention, however, seems to us to be but another way of making the argument that was made in Edison California Stores v. McColgan, 30 Cal. 2d 472, namely, that only the receipts of the instate entity should be used to determine whether the income is "attributable to sources both within and without the State" regardless of whether the instate entity contributes to or is dependent upon the entire business operation conducted by the same unit of ownership. The argument must be rejected as it was in the Edison California Stores case, supra. None of the cases relied upon by Appellant to support its contention applies to the situation before us. In Irvine Co. v. McColgan, 26 Cal. 2d 160, the only California case cited and the one most nearly in point, the court decided that a corporation engaged in business in this State was not doing business outside of the State where its products were sold outside of this State solely through independent brokers,

The test used to decide whether the income of a business is subject to allocation is whether or not the business is a unitary enterprise. See: Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472; Butler Brothers v. McColgan, 17 Cal. 2d 664, aff'd. 315 U.S. 501, And in Edison California Stores, supra, the court said, at page 481: "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate,"

We think the required dependency and contribution are present here. Although Appellant purchased locally some of the materials used in its operations, the parent corporation

furnished from its manufacturing plants or through its quantity purchasing a substantial proportion of the items used by Appellant. Manufacturing and purchasing in large quantities undoubtedly reduced costs, thus benefiting the Appellant, while at the same time the operations of Appellant contributed to the economies which benefited the entire business. Centralized management permitted a quality of personnel which, if each corporation were separately operated, would probably have been, in the words of the California Supreme Court in the Butler Brothers case, supra, "too expensive to be practicable." Centralized accounting also was provided, although Appellant did its own billing to customers. By spreading the costs of these services over the entire business, each branch and subsidiary enjoyed better service than it could have provided for itself. From the foregoing it appears that the operations of each branch and subsidiary both contributed to and depended upon the business of the others. We conclude, accordingly, that the entire business was unitary.

Appellant's statement that there is no case holding this doctrine applicable to a linen supply business is apparently true. But there is no need to find a case dealing with an identical business. Service businesses have been considered unitary. See: Pacific Fruit Express Co. v. McColgan, 67 Cal. App. 2d 93, and Appeal of Halliburton Oil Well Cementing Company, decided by this Board on April 20, 1955. Where contribution and dependency exist between the various parts of a business it should be considered unitary whether products or services are sold.

Actually, Appellant's primary argument is not that there is neither contribution nor dependency present here. Rather it contends that the test is how, "considering 'the necessities of the case,' the business had to be operated." (Emphasis by Appellant.) In support of this contention it cites State ex rel Maxwell v. Kent Coffee Mfg. Co., 204 N.C. 365, 168 S.E. 397, and Adams Express Co. v. Ohio State Auditor, 165 U.S. 194.

It appears that Appellant adverts to the earliest concept of a unitary business and has failed to note that the test has been liberalized since the time of the decisions it cites. See Butler Brothers v. McColgan, 17 Cal. 2d 664 at 667 and 668, and 315 U.S. 501 at 508; Edison California Stores, Inc. v. McColgan 30 Cal. 2d 472; John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214, appeal dismissed 343 U.S. 939. Adams Express Company, supra, was cited by the court in Butler Brothers, as a break from the theory that a physical link was a requisite of the unit rule. In none of these later cases did the court adopt the language emphasized by Appellant. In the light of these authorities we have no doubt that Appellant was engaged in a unitary business with National and Linen

Service Corporation.

Appellant argues that even if it may be considered to be engaged in a unitary business, the three factor formula of property, payroll and sales when applied to its business is arbitrary, unreasonable, and results in the taxation of extraterritorial income. To support this contention it has submitted voluminous statistical data purporting to show that these factors did not produce income in California to the same extent that they did in other states in which the unitary business was conducted. It points out that competition was keener in California, necessitating extra and more costly services and that its labor costs were higher here, all resulting in a lower margin of profit.

This is the same argument made by the taxpayer and rejected by the California Supreme Court in John Deere Plow Co. v. Franchise Tax Board, supra. In that case the court notes that the taxpayer showed variations from the national average in the ratios of wages to sales, property to sales and selling and general expenses to sales and yet it approved the use of the formula. It stated (at p. 224): "The fact that the taxpayer may show that according to a separate accounting system, the activities in the taxing state were less profitable than those without the state, or even resulted in a loss, does not preclude use of a formula as a method of apportionment of the unitary income .... Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process."

Appellant contends that its case is distinguishable from John Deere Plow Co., supra, in that it is proposing alternate formulas whereas the taxpayer in that case simply wished to use its separate account& system to determine the income upon which the tax should be computed. Appellant asks us to require the Franchise Tax Board to use one of the suggested alternate formulas because, it argues, the Franchise Tax Board may only use the property, payroll, sales formula until "a better and more accurate" one is pointed out to it. It is the Franchise Tax Board, however, and not this Board in which is vested the discretion to make such adjustments. The decision of the Franchise Tax Board may be set aside only if Appellant establishes by "clear and cogent evidence" that the refusal by that Board to make the desired adjustments in its formula allocation will result in "extraterritorial values" being taxed (Butler Brothers v. McColgan, 315 U.S. 501). Appellant's only evidence is its separate accounting data referred

to above. This does not satisfy the "clear and cogent evidence" requirement,

Cases sustaining the Franchise Tax Board where it required the use of a formula other than the property, payroll, sales formula, e.g., Pacific Fruit Express Co. v. McColgan, supra, and Matson Navigation Company v. State Board of Equalization, 3 Cal. 2d 1, do not support Appellant's position inasmuch as there is an obvious difference between sustaining the taxing agency's exercise of the discretion granted it and requiring it to adopt a specific formula urged upon it by a given taxpayer,

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the protests of United Linen Supply Company to proposed assessments of additional franchise taxes in the total amount of $73,878.09 for the income years ended March 31, 1941, to March 31, 1951, inclusive, be and the same is hereby sustained,

Done at Sacramento, California, this 19th day of February, 1958, by the State Board of Equalization,

Geo. R. Reilly, Chairman

J. H. Quinn, Member

Paul R. Leake, Member

Robert E. McDavid, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary